PROTECTION OF MAJORITY INTERESTS

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MR. RICHARDS: I would like to take as my thesis the position of the majority in today's corporate world, and I would say, pity the position of the majority. I think the present rules, to borrow from *Singer*,[1] are not "entirely fair" to the majority interests and if you are in the position of advising the majority it is a very difficult position indeed. In fact, I would say that under the present laws honest directors, carefully advised and with expert advice, cannot be at all certain that they can complete a transaction, not only without fear of a challenge, but without fear of successful challenge.

The intrinsic fairness test, I believe, is so severe that subsequent developments, if you are advising an energy company, for example, can always be used to impeach what was done. There are always two points of view existing at the time you complete the merger. Now, I'm not limiting my remarks to freeze-out mergers. We don't have those issues; you give them stock in the parent.

But the evidence around as to value is so all over the lot that if a subsequent development takes place such as deregulation, or OPEC raises its prices, or a probable deal turns into a sure deal, there is always somebody around at the time of the merger who had the opinion that that would happen.

Where you have to show the entire fairness, where you are deprived of any reasonable range of fairness of the merger that you were willing to consummate on one term, you may find out subsequently that you involuntarily merged at a much higher term. That is, the court will come in and say, well look, you didn't prove the entire fairness so you should have given them another tenth of a share or another $10 a share, or whatever it was.

What can you do to protect the majority interests and how good is the protection? Of course, you've got to go and hire an expert to protect yourself. But be careful as to how many experts you hire. Some people think, the more experts the merrier.

I have participated in some mergers where the parent company has gone out and hired three investment bankers. I have participated in situations where the parent and the subsidiary, who actually think

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1. Singer v. Magnavox Co., 380 A.2d 969 (Del. 1977).

they're independent although the plantiffs, of course, never believe it, but they have always operated as separate companies, where each side hires an expert, or two experts, and they have a negotiating subcommittee and they sit down and they try to battle this out as if they were adversaries.

But beware, because if you own 80% of the subsidiary the court will not believe that the subsidiary was acting independently and you will still have the entire fairness test.

By going out and hiring two sets of experts you may in fact have been creating tremendous evidence for your adversary because when the experts and the negotiating committee sit down to arrive at the price, of course the investment banker for the subsidiary will have all sorts of tables and theories from which he is trying to advocate a higher price, and if you do not agree to a merger price at the highest price that any one of these tables and theories advocate, then that table will appear in the discovery when the merger is challenged and all of the bargaining statements of the investment banker on behalf of your subsidiary arguing for a higher price or a higher asset value or a discount value, will come back to haunt you.

So it's a very difficult decision indeed, even sitting down to negotiate. It poses its own problems for the same reason. All the negotiating statements of the subsidiary will come back to haunt you.

Of course the safest thing perhaps is that the majority usually knows exactly what the subsidiary is worth. After all, their management has been familiar with the company more so than anybody else, and even if they are acting honestly and fairly the chairman of the board of the parent comes up with the value and says that's what it is.

Of course that's not going to be very successful where the ratio was born and came out of the head of the chairman. He then submitted it to his investment banker who, not surprisingly, says, yes that's fair. Of course that's not too convincing.

You also, of course, want to get independent experts. Now, what does that mean? In the *Schenley* case [2] the Court criticized the independence of the experts because they weren't really independent because of their previous investment banking relations. But if you get a truly independent expert, almost by definition you are going to get somebody that knows nothing about your company.

The expert that really knows the most about your company, that's been through your registration statement year after year, that's very familiar with your plant equipment, is your investment banker. Of course they will be impeached on the notion that they of course gave a

2. David J. Greene & Co. v. Schenley Indus., Inc., 281 A.2d 30 (Del. Ch. 1971).

favorable opinion in the hopes of continuing as the investment banker of the parent.

You also should allow a sufficient period of time if you get somebody who is unfamiliar with your company. A sufficient period of time should elapse for the investment banker to really become familiar with your operation. There are a number of cases in which I think investment bankers haven't really been allowed enough time to function.

When you pay the fees that are involved today, a quarter of a million, a half million, three-quarters of a million, they will put teams of people in to go through your operation. They will send 20 to 30 people, and in 2 or 3 weeks they will tell you that they can come up with an opinion as to value.

But I caution you to beware of that because the other side will always be able to demonstrate that the people involved in this massive sort of investment package discovery expedition are really not intimately familiar with your business and didn't meet the right people when they went there, and didn't have enough time. So I think the thing to do is to take enough time to allow your experts to become indisputably familiar with your operations in coming up with these values. Or, bite the bullet and take in an investment banker who has been with you for years but whose integrity is unimpeachable.

You should also look at the investment bankers as to who is going to be your witness. There are plenty of shrewd analysts who don't make very good witnesses. So when you are interviewing the investment bankers you want to find out who is going to be the witness and his willingness and agreement to testify in support of his opinion.

I think Al Terrell, or somebody mentioned in his outline, that you should have independent counseling in the subsidiary. I think if the subsidiary is receiving its advice from the parent, that could be a source of difficulty. I don't see any difficulty in having an independent counsel for the subsidiary, but I do see some difficulties in having two sets of investment bankers.

Most of this, generally speaking, results in the fact that a premium is awarded. All the investment bankers today tell you, well, you have to give the minority some premium. I submit that the flip side of this is that the minority is being given a premium above the value of the stock and the shareholders of the majority company are suffering. Indeed, in a number of recent transactions in which I have been involved, the true insiders believe that the proper suit to be brought would have been by shareholders of the majority company for giving away too much to the minority in an effort to make the transaction bullet-proof.

But of course the plaintiffs in that case would not have the benefits of this fairness test. So I suggest that that test must decide who gets to be sued, and I suggest that it is a jurisprudentially unsatisfactory situation where honest people, well advised, cannot be certain of going forward with a business transaction without fear of having either it set aside or the terms of it involuntarily changed.

I think that we can see in the outline that reliance on the experts is not really going to change the burden of proof. That was established in *Greene v. Dunhill*[3] that notwithstanding Delaware Code 141-E, that reliance on independent experts in a merger situation in coming up with a value, doesn't shift the burden of proof and it doesn't help you out unless he is a persuasive witness in court.

What about approval by the majority of the minority? Can you somehow sacrifice your role of majority and say, look, I'm not the majority. I'm going to leave it up to the little minority to decide whether my transaction goes forward. The law seems to be that you can do that in everything but a merger. However, it doesn't really explain, there's no policy discussion in our cases as to why not in a merger.

In stock option cases you can see that you can shift to the business judgment rule by stockholder ratification. That hasn't been changed by *Singer*. Vice Chancellor Hartnett recently held that in *Michelson v. Duncan.*[4] There are two cases that say that ratification by a majority of the minority does not shift the burden in a merger situation. One is the unreported decision of *Bon Ami*[5] by Chief Justice Seitz, then Chancellor and the other is *Greene v. Dunhill* citing the *Bon Ami* case. In neither case did they really discuss why not.

Of course in advocating that approval by the majority of the minority should shift the burden, you have to, of course, withstand an attack on your full disclosure. Obviously if you haven't made full disclosure to the minority shareholders, why then their judgment as to whether the transaction is fair or not, of course, is no good. So you will always be faced with the argument, if you attempt to assert this defense, that you didn't make full disclosure and that you failed to tell them the various factors which plaintiff will urge are the reasons why the ratio arrived at is not fair.

There has been a specific holding in *Schiff v. RKO Pictures*[6] that approval of the offer by affirmative vote of the majority of the stock,

3. David J. Greene & Co. v. Dunhill Int'l, Inc., 249 A.2d 427 (Del. Ch. 1968).

4. Michelson v. Duncan, 386 A.2d 1144 (Del. Ch. 1978).

5. Stryker & Brown v. The Bon Ami Co., C.A. 1945 (Del. Ch. 1964).

6. Schiff v. RKO Pictures, 104 A.2d 267 (Del. Ch. 1954).

other than the shares owned by Howard Hughes who owned 50% there, shifted the burden of proof. Query: why should such a result have attained and availed at that case and not in a merger case?

In corporate opportunity cases ratification by a majority of the minority has been sufficient to shift the burden back to the business judgment test. In *Saxe v. Brady*,[7] where an allegedly excessive fee was paid to an investment advisor of an investment company, the ratification by the majority of the minority was successful in putting the burden on the plaintiffs to show that the business judgment rule had been violated.

In a very recent decision by Vice Chancellor Hartnett in *Schreiber v. Bryan*[8] where a transaction was approved by a majority of the minority, there the transaction was structured specifically, and this may, or should, make a difference it seems to me, specifically that it would not go through unless a majority of the minority approved it. The majority said it would vote its stock in exact proportion to the vote of the minority and that there was full disclosure. But Vice Chancellor Hartnett said that case had to go to trial and that the burden would be on the defendant to come forward with evidence that the transaction was fair.

But curiously he changed the test. He shifted the burden, and this really hasn't been remarked on by people who have been talking about this case, on reargument he said that the defendant had the burden of going forward with the evidence as to fairness, but the test will be, that is the amount of the burden, will be whether or not it is within reasonable bounds. That is, it seems to be the business judgment rule, but putting the burden on the defendant to go forward.

We come then, I suppose, to some philosophical questions as to whether or not the ratification by the majority of the minority should be sustained in a merger case. Of course, I suppose the difficulty with an absolute rule is, how much of a minority do you need? Does it depend upon the number of minority shareholders, or does it depend on the substantiality in economic terms of their interest? Does it depend upon their sophistication? Indeed, how would you ever demonstrate or prove the sophistication of minority shareholders?

Certainly questions like this have troubled our courts. In a recent case there was only a 4% minority and the court said that to apply the theory of ratification advanced by the defendants, namely the majority of the independent stock which voted on the sale who did in fact favor

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7. Saxe v. Brady, 184 A.2d 602 (Del. Ch. 1964).

8. Schreiber v. Bryan, C.A. 4250 (Del. Ch. 1978).

it, would under the facts of the case emasculate the principle of stockholder approval, such interests making up only 1.362%.

You can see that when you have a situation like that it is going to be difficult to say that 1.3% of the stockholders reviewed what is in many cases 100, 150, 200 pages of proxy material and voted in favor of the transaction. Somehow that's unconvincing to the courts as to overcoming the inherent opportunities for unfairness where one party stands on both sides. I think you will have difficulties with the amount of the minority stockholders.

Further, I think in some of the cases the argument is made that ratification by the majority of the minority should somehow shift the burden was an after the fact argument. That is, in most cases it was a fortuitous circumstance that the majority shareholder had seized upon after the merger was challenged. The query is whether it should make any difference if the approval of the merger is contingent on that. Perhaps it would.

I suppose you could attack the votes of a minority shareholder as really not being meaningfully cast where they are told at the outset that the majority stockholder, who holds 80% of the stock, is going to vote in favor of it. Maybe they just go along for the ride because they figure that's going to pass anyhow, so why should they get their heads hot from reading the complicated proxy material.

Maybe if the proxy material says, well, this outcome is going to depend upon your vote, you've got to read this carefully, you're going to decide, maybe that should make a difference as to how much weight to give to the judgment of the minority shareholders.

Finally, maybe a question for the panel would be, is a merger really such a fundamentally different transaction that the effect of ratification by the majority of the minority, or the majority of the independent shareholders, that the effect of that ratification should be different in mergers than it is in any other situation under the corporate law, than it is in stock options, than it is in paying investment fees, than it is in sales of assets.

Why is that different? Is there an opportunity here to somehow shift the balance back without things being out of kilter in permitting ratification to bring a firm back under the business judgment rule?